Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Special Access Rates for Price Cap	)	WC Docket No. 05-25
Local Exchange Carriers	)	
	)	
AT&T Corp. Petition for Rulemaking to Reform	)	
Regulation of Incumbent Local Exchange Carrier	)	RM-10593
Rates for Interstate Special Access Services	)	

COMMENTS OF ATX COMMUNICATIONS SERVICES, INC. BRIDGECOM INTERNATIONAL, INC. BROADVIEW NETWORKS, INC. PAC-WEST TELECOMM, INC. US LEC CORP. U.S. TELEPACIFIC CORP. D/B/A TELEPACIFIC COMMUNICATIONS

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Dated: June 13, 2005

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Declaration of Lee Selwyn (dated Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004)	Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, *inter alia*, "Letter from C. Frederick Beckner III to Marlene H. Dortch, dated November 8, 2004 (with ex parte Declaration of Lee Selwyn)") (filed Dec. 7, 2004)
Reply Declaration of Lee Selwyn (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004)	Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, *inter alia*, "Reply Declaration of Lee Selwyn (October 19, 2004)") (filed Dec. 7, 2004)
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Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets	Letter from Brian R. Moir, counsel for the Special Access Reform Coalition, to Marlene H. Dortch, Sec'y, Federal Communications Commission, Attach. Phoenix Center Policy Paper Number 18 (George S. Ford & Lawrence J. Spiwak, *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets* (2003)) (filed July 18, 2003)

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ATX Communications Services, Inc., BridgeCom International, Inc., Broadview Networks, Inc., Pac-West Telecom, Inc., US LEC Corp, and U.S. Telepacific Corp. d/b/a Telepacific Communications submit these comments in the above- captioned proceeding concerning reform of regulation governing pricing for interstate special access services provided by incumbent local exchange carriers subject to price cap regulation.[1]

I. INTRODUCTION AND SUMMARY

The FCC's current framework governing price cap ILEC provision of special access service is not producing reasonable rates and needs substantial revision. The Commission's "predictive judgment" in its 1997 *Access Charge Reform Order*, 1999 *Pricing Flexibility Order*,

[1] *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Notice of Proposed Rulemaking, WC Docket No. 05-25 and RM-10593, FCC 05-18, released January 31, 2005 ("*NPRM*").

and 2000 *CALLS Order* that price cap regulation could be eased because competition would be sufficient to constrain incumbent pricing flexibility has proved erroneous. This is so for a number of reasons that are not strictly within the scope of this proceeding, including perhaps that competition from CLECs has been "regulated away."[2] Unfortunately, prices for interstate special access where BOCs have been relieved from price cap regulation have not been reduced and, in some cases, have actually increased. To make matters worse, the *CALLS Order* guaranteed that even special access prices that remain subject to price caps would be unreasonable by eliminating X-Factor reductions based on productivity.

As a first step to move towards reasonable special access prices, the Commission should immediately adopt substantial interim relief pending completion of this proceeding including: (a) an interim X-Factor of 5.3%; (b) a roll-back of pricing flexibility prices to price cap levels; and (c) a prohibition going-forward on price increases.

The Commission's permanent program for reforming special access regulation should reinitialize all special access prices at or closer to forward-looking costs that are found in a competitive market by using state-approved UNE rates as benchmarks. If the Commission does not employ this approach to reinitialize prices, the Commission should at least do so based on a 11.25% (or lower) rate-of-return applied to ILECs' embedded costs.

Reinitialized special access prices should then be subject to a modified price cap regime. The new price cap regime should apply a productivity-based X-Factor to special access prices, impose a sharing requirement for excessive earnings, and establish separate baskets for DS1, DS3, mass market broadband and DSL, and retail special access service.

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[2] *Junk This*, Telephony, May 23, 2005, p. 18, *also available at* http://telephonyonline.com/mag/telecom_junk/index.html.

Phase II relief should be abolished under revised pricing flexibility rules because experience has shown that absent price caps BOCs will not reduce, and will even increase, special access prices given the present state of competition. To the extent any relief from price cap regulation is provided under revised pricing flexibility rules, ILECs should be permitted only to revise prices downward. There is no justification for permitting ILEC s to raise prices based on a showing of competition since competition should lead to reduced ILEC special access prices.

The Commission should also determine that region-wide commitments and restrictions on use of UNEs under BOC optional calling plans are anticompetitive and unlawful. The Commission should also establish a "fresh look" opportunity to permit special access customers to obtain better prices where available.

II. PRICING FLEXIBILITY AND THE *CALLS* PLAN HAVE FAILED TO PRODUCE COMPETITIVE SPECIAL ACCESS PRICES

A. The FCC's "Predictive Judgment" And Market-Based Approach Have Not Produced Forward-Looking Special Access Prices

In the 1997 *Access Charge Reform Order* the Commission announced that "access charges should ultimately reflect rates that would exist in a competitive market."[3] The Commission considered two separate approaches to achieve that objective -- a prescriptive approach in which the Commission by regulation would set rates at forward-looking economic costs, and a market-based approach that relies on competition to reduce prices.[4] The Commission decided, based on its experience and record evidence, that a market-based approach to reducing interstate access charges would better serve the public interest.[5] It concluded that

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[3] *Access Charge Reform Order*, ¶ 42.

[4] *Access Charge Reform Order*, ¶¶ 44, 263-265.

[5] *Access Charge Reform Order*, ¶ 44.

emerging competition would provide a more accurate means of moving access prices to forward-looking cost-based levels.[6]

In order to implement its market based approach, the Commission in the *Access Charge Reform Order* modified its rules governing access charge rate structure so that ILECs could voluntarily reduce rates to levels that reflect the development of competition and the "true" cost of service.[7] Subsequently, in the 1999 *Pricing Flexibility Order*, the Commission established a program of permitting ILECs to escape price cap regulation based on showings of competition that were based on a "predictive judgment" that competition in certain areas would constrain BOCs' special access rates and force them to cost-based, forward-looking levels that characterize a competitive marketplace.[8]

The Commission in the *CALLS Order* further implemented its market-based approach by adopting a five-year plan negotiated by some parties in the industry for reducing access charges, although not to forward-looking costs.[9] Price cap carriers were offered the choice of completing the forward-looking cost studies required by the *Access Charge Reform Order* or voluntarily making the rate reductions required under the five-year CALLS plan.[10] Unsurprisingly, all price cap carriers avoided submitting forward-looking cost studies and opted for the CALLS plan.[11]

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6 *Access Charge Reform Order*, ¶ 44.

7 *Access Charge Reform Order*, ¶¶ 42, 263.

8 *See Pricing Flexibility Order*, ¶ 154.

9 *CALLS Order*, ¶¶ 36-42.

10 *CALLS Order*, ¶¶ 29, 56-62.

11 *See Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. § 160(c) from the Deadline for Price Cap Carriers to Elect Access Rates Based on the CALLS Order or a Forward Looking Cost Study*, CC Docket No. 01-131, Order, 17 FCC Rcd 24319, 24320, ¶ 3 (2002).

When it adopted the *CALLS Order*, the Commission was hopeful that, by the end of the five-year plan—July 1, 2005, "competition would exist to such a degree that deregulation of access charges for price cap LECs would be the next logical step."[12] It also noted that "[a]s competitors utilizing a range of technologies, including cable, cellular, MMDS and LMDS, continue to enter the local exchange market, we expect that rates will continue to decrease."[13]

Unfortunately, the Commission's predictive judgment that competition would by now have forced special access prices closer to the Commission's goal of forward-looking economic costs was erroneous. A review of the stark differences between special access and UNE prices, for example, demonstrates that special access prices are far above forward-looking economic costs. AT&T has submitted a comparison of the BOCs' tariffed DS1 and DS3 interstate special access rates, on a state-by-state basis with the rates for functionally equivalent DS1 and DS3 loop and transport UNEs set under the Commission's forward-looking, economic cost methodology,[14] including areas where BOCs have obtained Phase II pricing flexibility.[15]

As shown in the chart below, in virtually every instance, the BOCs' special access rates far exceed economic costs. For example, Verizon North's and SBC-Ameritech's "discounted/Optional Pricing Plan" ("OPP") DS1 special access rates for a 10-mile circuit subject to pricing flexibility are on average 129 percent and 171 percent higher than comparable

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[12] *CALLS Order*, ¶ 35.

[13] *CALLS Order*, ¶ 166.

[14] *Accord, Local Competition Order*, ¶ 679 ("we believe that our adoption of a forward-looking cost-based pricing methodology… establish[es] prices… based on costs similar to those incurred by the incumbents."); *Id.*, ¶ 672.

[15] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 17-20 Attachments 1 & 2.

UNE rates, respectively.[16] For services still subject to price cap regulation, the BOCs' month-to-month DS1 and DS3 special access services are routinely more than 100 percent higher on average than the comparable UNE rates, and sometimes they are even 200% or 500% higher.

	DS1 10-Mile Stand-Alone Circuits[17]			
	PC Cap -vs- UNE		Pr. Flex. – vs UNE	
	Mo.-to-Mo.	OPP (3yrs)	Mo.-to-Mo.	OPP (3yrs)
BellSouth	217.00%	104.00%	233.00%	134.00%
Ameritech	505.00%	156.00%	508.00%	171.00%
SWBT	123.00%	52.00%	157.00%	52.00%
Verizon S	130.00%	74.00%	183.00%	112.00%
Qwest	123.00%	97.00%	185.00%	152.00%
Verizon N	144.00%	83.00%	206.00%	129.00%

This comparison is abundantly appropriate because special access services are provided over the same facilities and are functionally equivalent to high capacity loop and transport UNEs and UNE prices are set at forward-looking, economic costs. Accordingly, UNE prices provide an excellent benchmark by which to assess whether the BOCs' special access prices are at such levels and, therefore, just and reasonable.[18]

To add, the United States Supreme Court found that the TELRIC forward-looking cost estimation upon which UNE rates are derived is a fully valid and compensatory method of calculating a Bells' true costs.[19] In fact, TELRIC is overly compensatory given that costs must be calculated on the basis of existing wire center locations and given and inevitable regulatory

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[16] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶¶ 17.

[17] Information pulled from Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), Attachment 1 at 1.

[18] *See Access Charge Reform Order*, ¶¶ 267-68 (explaining that by February 8, 2001, it expects to have "additional regulatory tools by which to assess the reasonableness of access charges").

[19] *See Verizon*, 535 U.S. at 467-472.

lag in TELRIC price adjustments.[20] Thus, the BOCs' ability to charge special access rates that are multiples of their forward-looking costs demonstrates that their special access services are not subject to meaningful competitive discipline as the Commission had otherwise hoped.

Thus, given the wide disparity between UNE prices and special access prices, even where pricing flexibility has been granted, it is clear that special access prices grossly exceed the forward-looking pricing that the Commission hoped a market-based approach to special access pricing would achieve.

B. BOC Special Access Rates-of-Return Demonstrate that Special Access Prices Are Unreasonable

Apart from the fact that special access prices remain far above forward-looking economic costs, BOCs' extraordinarily high rates-of-return also demonstrate that the Commission's regulatory framework governing special access pricing is not producing reasonable rates. As of the year ended 2004, the BOCs' special access rates of return were as follows: Verizon – 31.6%, SBC – 76.2%, Qwest – 76.8% and BellSouth – 81.2%.[21] Overall, the BOCs averaged an incredible 53.7 percent rate-of-return.[22]

The record before the Commission already demonstrates that these returns are not short term phenomena or aberrations resulting from one-time change in circumstance. Indeed, since the passage of the Telecommunications Act of 1996 to the present, the average special access

[20] *See Verizon*, 535 U.S. at 469-470. BOCs have been unable to identify a single instance in which state-adjudicated, cost-based rates for high capacity facilities depart substantially from the BOCs' costs. *See* Worldcom Comments at 11 (Jan. 23, 2003). Nor have they identified any high-capacity UNE rates that fail to include an allocation of common costs. *Id.*

[21] WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 9 (May 10, 2005).

[22] WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 9 (May 10, 2005).

category earnings have steadily increased from 8.25 percent in 1996 to a remarkable 43.7 percent at the end of 2004 and jumped to 53.7 percent at the end of 2004.[23]

These high rates-of-return seriously harm ratepayers. A comparison of year-end 2003 data with the FCC's most recently authorized return level for interstate service of 11.25 percent reveals that excessive special access charges were resulting in overcharges equal to $5.5 billion, which otherwise means that BOCs are overcharging special access ratepayers $15 million per day.[24] During 2004, the BOCs' excessive overcharges went up 15 percent - the BOCs' overcharges yielded a whopping $6.4 billion in excessive special access revenues or $17.5 million per day.[25]

The Commission should reject BOCs' arguments that ARMIS data is irrelevant to assessing their rate-of-return for interstate special access. ARMIS data is the BOCs' own data and reporting and it strains credulity for BOCs to claim it should be ignored. Moreover, ARMIS data is completely appropriate for evaluating rate-of-return using BOCs' embedded costs and was designed for that purpose. Further, ARMIS data is showing such high rates-of-return that no amount of tweaking would show that BOCs are not earning unconscionable rates-of-return.[26]

Given this, the rates are *per se* unlawful. The United States Supreme Court and lower courts have consistently held that where "returns have greatly exceeded a fair percentage of

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[23] WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 9 (May 10, 2005); ETI White Paper at 28-29; *see also NPRM*, ¶ 35 (noting that over the last seven years (1998-2003), the BOCs' collective special access rates have been 18, 23, 28, 38, 40, and 44 percent, respectively).

[24] ETI White Paper at 7-8 Table 1.1; WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 6 (May 10, 2005).

[25] WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 6 (May 10, 2005).

[26] *See* ETI White Paper at 29-28; Reply Declaration of Lee Selwyn (Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004) at 47-83; Declaration of Lee Selwyn (Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 17-28; WC Docket No. 05-65, Reply Declaration of Lee Selwyn at 49-55 (May 10, 2005).

return upon a fair base, it follows as a matter of law that the rates charged . . ., instead of being 'just and reasonable' …[are] excessive."[27] Further, the Commission made clear when the price cap regime was implemented, that observed returns remain the litmus test for determining whether the specific price cap rules are working to protect consumers from unjust and unreasonable rates or if the rules need to be overhauled. The Commission has stated that a "price cap approach cannot free carriers to earn excessive [supracompetitive] profits in light of their costs."[28] Also, the Commission has previously stressed that its price cap regime would include "ongoing monitoring" and that a future "comprehensive review" of the price cap mechanism would "focus prominently on the carrier costs and profits."[29] Accordingly, the BOCs' astronomical rates-of-return should be accorded substantial weight in assessing the need to reform special access pricing rules.

Apart from any other information in the record, these high rates-of-return by themselves demonstrate that special access prices are unreasonable and unlawful and that the Commission's regulatory framework governing interstate special access is not working and needs to be overhauled. As the Commission has recognized, only firms with market power can expect to consistently earn profits that greatly exceed economic profits.[30] The sustained and increasing

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[27] *Potomac Elec. Power Co. v. Public Utils. Comm'n of the District of Columbia*, 158 F.2d 521, 523 (D.C. Cir. 1947) (quoting *Dayton-Goose Creek Co. v. United States*, 263 U.S. 456, 483 (1924) (emphasis added).

[28] *AT&T Price Cap Order*, 4 FCC Rcd 2873, ¶ 885 .

[29] *AT&T Price Cap Order*, 4 FCC Rcd 2873, ¶ 885.

[30] *Local Competition Order*, ¶ 700 ("Normal profit is embodied in forward-looking costs because the forward-looking cost of capital, i.e., the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing network elements"); Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission (issues 1992, revised 1997) ("Market power to a seller is the ability to profitability to maintain prices above competitive levels for a significant period of time").

supracompetitive returns irrefutably prove that the BOCs possess market power in provision of special access service and that they are abusing it by assessing unreasonable rates.

C. Pricing Flexibility Has Permitted "Substantial and Sustained" Price Increases

The Commission's special access rules are also not working because BOCs are raising prices where they have been granted Phase II pricing flexibility. Starting in the fall of 2000, BOCs have sought and have been granted pricing flexibility in numerous MSAs. Where they have obtained Phase II pricing flexibility, the BOCs have maintained or increased their rates above price cap levels.[31]

For example, Verizon-North's OPP pricing flexibility rates for a ten mile DS1 are 30 percent higher on average than price cap rates.[32] Qwest's, Verizon-South's, and BellSouth's are 28, 22, and 15 percent higher, respectively.[33] The results for a zero-mile DS-1 circuit are similar.[34] For instance, pricing flexibility rates, on average, are higher in Verizon-North, Qwest, and Verizon-South incumbent serving areas by 27, 18, and 15 percent.[35] SBC has also sustained increased pricing in those areas where competition was expected to discipline its pricing. Recent data shows that it currently charges customers located in areas in which pricing flexibility has

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[31] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19-20.

[32] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19.

[33] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19.

[34] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19.

[35] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19.

been granted 25 percent more than the prices in effect in the areas still subject to price cap regulation.[36]

Remarkably, the BOCs assess these higher rates in the largest cites, where the FCC predicted that competition was the most advanced and would deter rate increases.[37] And, these are more densely populated areas and thus would typically be characterized by costs that are lower than those in areas in which BOCs have not received Phase II pricing flexibility, forcing reductions, not increases, in prices. The fact that the BOCs' prices are much higher, as a general matter, in the lower cost areas is telling proof that BOCs' retain overwhelming market power (and effectively have monopoly power) in every local market, including those with the most competitive entry. Although BOCs argue that this is not the case, such arguments have been fully refuted.[38] The results of Phoenix Center's econometric model provides a regression analysis that reveals and corroborates the fact that these price increases are derived from market power rather than price adjustments reflecting costs.[39]

Although BOCs have maintained their special access rates at pre-pricing flexibility levels in a few areas, these rates have, in effect, increased above price cap levels. If these services had remained subject to price cap regulation, the BOCs would have been required to apply substantial X-factor reductions to these rates in both 2001 and 2002. The elimination of price cap regulation for these services has allowed the BOCs to avoid those X-factor reductions (and keep rates at pre-pricing flexibility levels).

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[36] WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 17 (May 10, 2005).

[37] Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 20.

[38] Declaration of Lee Selwyn (Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 3-16.

[39] *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in the Telecommunications Markets*, at 27.

At bottom, the pricing conduct of the BOCs in markets where Phase II pricing flexibility has been granted demonstrates that the level of competition, even in the most competitive of those markets, has not reduced special access rates to levels indicative of a truly competitive market.[40] Because of the lack of competition, BOC have been able to implement not only substantial and sustained price increases but also astounding profit levels that now average an incredible 54 percent.[41] In a competitive market, BOCs could not raise prices without attracting competitors who would be able to take away customers by charging far lower (but nonetheless compensatory) prices.[42] By increasing their special access prices well above forward-looking compensatory costs, BOCs clearly have not been constrained by the threat of existing or future competitors eroding their market share.[43] Consequently, the Commission cannot yet rely on competition to protect consumers from these excessive rates and must immediately step in by prescribing rates and establishing a new price cap regime.[44]

As the Commission noted in the *NPRM*, the level of competition in a market can also be determined based on whether there has been substantial and sustained price increases.[45] Because BOCs have maintained or raised their special access rates when given pricing flexibility and have been able to both retain customers and increase sales in the wake of raising prices, the conclusion is inescapable that BOCs continue to possess market power in provision of special access service. The BOCs' special access rates are patently unlawful and the Commission

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[40] ETI White Paper at 36-37.

[41] ETI White Paper at 36-37; WC Docket 05-65, Reply Declaration of Susan M. Gately ¶ 9 (May 10, 2005).

[42] ETI White Paper at 38.

[43] ETI White Paper at 38.

[44] *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in the Telecommunications Markets*, at 3 & 9

[45] *NPRM*, ¶ 73.

should no longer allow "dominant firms under its jurisdiction from gouging consumers and stymieing competition via unfettered abuse of their market power." [46]

III. IMMEDIATE INTERIM RELIEF IS NECESSARY

As envisioned in the *NPRM* initiating the above-captioned proceeding, the Commission should establish interim requirements pending completion of this proceeding that will begin to move price cap ILEC special access prices towards a reasonable level.[47] The Commission should promptly establish for special access an interim X-Factor of 5.3 percent.[48] Absent application of an X-Factor, special access prices are unreasonable *per se* because they do not reflect productivity gains that characterize the telecommunications industry, effectively allocating all the benefits of productivity gains to price cap ILECs and none to their customers.

In addition, the Commission should establish interim requirements directed at moving special access prices towards more reasonable levels in areas where price cap ILECs have qualified for Phase II pricing flexibility. As noted, when the Commission established pricing flexibility, it anticipated that the level of competition in the marketplace that would be captured by the adopted pricing flexibility triggers would put *downward* pressure on special access rates and cause them to be *reduced* to cost-based and forward-looking levels.[49] The Commission believed that BOCs that obtained Phase II pricing flexibility would begin lowering special access

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[46] *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in the Telecommunications Markets,* at 4. AT&T Reply at 22-23 (1/23/03).

[47] *NPRM*, ¶ 131.

[48] *NPRM*, ¶ 131.

[49] The Commission's longstanding goal is that "interstate access charges reflect the forward-looking costs of providing those services." *See NPRM*, ¶ 65 & n.174 (citing *Access Charge Reform Order*, ¶¶ 42-49, 258-74).

rates in specific markets (*i.e.*, MSAs) in response to competitive pressures.[50] Indeed, when the Pricing Flexibility Order was adopted, two Commissioners specifically acknowledged this and one stated that "[b]y first providing incumbents with some downward pricing flexibility for high-capacity services, we allow them to respond to the new competitive marketplace for these services. Consumers should also benefit from lower prices."[51]

As discussed, however, contrary to the Commission's expectations, competition has not constrained special access pricing.[52] Substantial evidence in the record demonstrates that, as noted in the *NPRM* and other filings in this proceeding, price cap ILECs have not used this flexibility to lower special access prices in any MSA for which they have received Phase II pricing flexibility. Rather, they have either maintained or raised rates in each of these MSAs.[53]

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[50] *See NPRM*, ¶ 70, n.182 (citing *Pricing Flexibility Order*, ¶¶ 67-69, 72-74, , 153-54); *see also Pricing Flexibility Order*, ¶¶ 122, 136. Although the Commission recognized that Phase II pricing flexibility may enable BOCs to increase prices to the extent their services are below cost, *Pricing Flexibility Order*, ¶ 155, that is not the case given the excessive special access returns that BOCs are experiencing.

[51] *See Pricing Flexibility Order*, 14 FCC Rcd at 14390 (Separate Statement of Commissioner Ness); *see also* 14 FCC Rcd at 14391 (Separate Statement of Commissioner Furchtgott-Roth stating "It is very difficult to rationalize any occasion where the government stands between consumers and lower prices….Today's Order establishes triggering mechanisms that will open the door to a degree of regulatory relief that will, in turn, provide lower prices to consumers.").

[52] Although under price caps the Commission permitted BOCs to reduce prices in an unconstrained fashion, this has not occurred. *Access Charge NPRM, Order, and NOI*, 11 FCC Rcd at 21487-88, ¶ 305 (the Commission eliminated the lower service band indices and concluded that this would lead to lower prices and encourage LECs to charge rates that reflect the underlying costs of providing exchange access services. It also found that the PCI and upper pricing bands adequately control predatory pricing and that greater downward pricing flexibility would benefit consumers both directly through lower prices and indirectly by encouraging only efficient entry.).

[53] *See NPRM*, ¶ 70 & n.183 (citing AT&T Petition for Rulemaking at 11-12; Worldcom Comments at 7-8); *see* RM-10593, December 7, 2005 Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, attachments: "Declaration of Lee Selwyn (October 4, 2004)" at 68-69 (explaining that "there is abundant evidence demonstrating that the RBOCs have the power to increase their special access rates in the wake of the *Pricing Flexibility Order*"),

Pricing flexibility rules, therefore, fail to identify where competition is sufficient to prompt rate reductions to forward-looking cost-based levels or constrain BOCs from raising rates. Significantly, although the Commission had hoped that competition would have caused special access rates to decrease to forward-looking cost-based levels by now, it also said that it would act proactively, if necessary, to accomplish this.[54]

"Reply Comments of AT&T" at 83 (explaining that "the Bells' have stiffly increased prices in pricing flexibility areas."), "Reply Declaration of Lee Selwyn (October 19, 2004)" at 58 (finding "that higher pricing flexibility rates were substituted for lower price cap rates"), "Letter from C. Frederick Beckner III to Marlene H. Dortch, dated November 8, 2004 (with ex parte Declaration of Lee Selwyn)" at 5 (demonstrating that Verizon's own analysis proves that "Verizon has raised prices in pricing flexibility areas"), "Letter from C. Frederick Beckner III to Marlene H. Dortch, dated December 7, 2004" at 2 (proving "that Bellsouth's special access rates in areas where it has obtained pricing flexibility are well above what it charges in whereas where it remains subject to price caps") (filed Dec. 7, 2004); *see* letter from Colleen Boothby, Counsel for Ad Hoc Telecommunications Users, to Marlene Dortch, Secretary, FCC (Sep. 13, 2004); Letter from Colleen Boothby, Counsel for Ad Hoc Telecommunications Users, to Marlene Dortch, Secretary, FCC, attaching Competition in Access Markets: Reality or Illusion A proposal for Regulating Uncertain Markets, at 35-37 (Aug. 26, 2004) (explaining that persistent excessive RBOC pricing of special access services in areas where Phase II Pricing Flexibility has been granted demonstrates that the level of competition in those areas is not sufficient to constrain monopoly pricing practices); *see also* WC Docket No. 05-65, Reply Comments of Ad Hoc Telecommunications Users Committee, Reply Declaration of Susan M. Gately, at 13-14 (May 10, 2005) (for a 10-mile DS1 special access circuit, SBC charges 25% more where it has pricing flexibility); WC Docket No. 05-65, COMPTEL/ALTS Reply Comments, Lee Selwyn Reply Declaration at 49-57 (May 10, 2005).

[54] In 1997, the Commission stated that "[w]here competition has not emerged, we reserve the right to adjust the rates in the future to bring them in line with forward-looking costs. To assist us in that effort, we will require price cap LECs to submit forward-looking cost studies of their services no later than February 8, 2001 and sooner if we determine that competition is not developing sufficiently for the market-based approach to work." *Access Charge Reform Order*, 12 FCC Rcd at 16003, ¶ 48. However, in the *CALLS Order*, the Commission adopted a five-year interim regime that was designed to phase out implicit subsidies and (as it pertains to access charges) to move towards a more market-based approach to rate setting. *See CALLS Order*, 15 FCC Rcd at 12965, 12977-79, ¶¶ 4, 36-42. In adopting this plan, the Commission offered price cap carriers the choice of completing the forward-looking cost studies required by the *Access Charge Reform Order* or voluntarily making the rate reductions required under the five-year CALLS plan. *See id.*, 15 FCC Rcd at 12974, 12983-86, ¶¶ 29, 56-62. The Commission permitted carriers to defer the planned forward-looking cost studies in favor of the CALLS plan because it found the plan to be "a transitional plan that move[d] the marketplace closer to economically rational competition, and it [would] enable [the Commission], once such

Accordingly, as further interim relief, the Commission should first, prohibit any further price increases where BOCs have already obtained Phase II pricing flexibility. This is essential to prevent further harm caused by the inability of current pricing rules to accurately identify where competition is sufficient to constrain prices. The Commission should also require price cap ILECs to roll back to price cap levels any prices that have been increased since Phase II pricing flexibility was granted. This will at least preclude further harm caused by these price increases, although not undo the exorbitant, non-cost based prices that special access customers have paid. Unlike the relief AT&T sought in its petition for rulemaking in this proceeding, this relief "only restor[es] the rate levels that would have been in place had the Commission never adopted the pricing flexibility rules."[55] In addition, the relief is justified to avoid further market disruptions that would be caused if BOCs with special access pricing flexibility continued to increase special access rates while the Commission "moves towards broad reforms" in this proceeding.[56] Both of these aspects of interim relief would be administratively simple for price cap ILECs to implement and would not burden the Commission.

Along with ordering the above interim relief, the Commission should order "fresh look" relief. As the Commission has noted, market power can be exercised through high prices and

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competition develops, to adjust our rules in light of relevant marketplace developments." *See id.*, 15 FCC Rcd at 12977, ¶ 36. Unsurprisingly, all price cap carriers avoided submitting forward-looking cost studies and opted for the CALLS plan. *See NPRM*, ¶ 14 (citing *Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. § 160(c) from the Deadline for Price Cap Carriers to Elect Access Rates Based on the CALLS Order or a Forward Looking Cost Study*, CC Docket No. 01-131, Order, 17 FCC Rcd 24319, 24320, ¶ 3 (2002)).

[55] *NPRM*, ¶ 130.

[56] *NPRM*, ¶ 130 (citing *Competitive Telecommunications Ass'n v. FCC*, 309 F.3d 8, 14 (D.C. Cir. 2002)).

also through tariff terms and conditions designed to exclude competitors from the market.[57] Growth commitments, prohibitions on using UNEs, and limits on the ability of the customer to purchase service from other providers are examples of terms and conditions that can be unreasonable. As interim relief, the Commission should establish a fresh look opportunity that would permit special access customers to escape contract provisions and seek service from competitive alternatives, if available.[58] This will also help to move special access pricing toward more reasonable levels on an interim basis pending adoption of permanent reforms.

Contrary to recent claims by Verizon,[59] interim relief would not raise any issues under the Administrative Procedures Act because the NPRM in this proceeding specifically contemplated interim relief and the record gathered to date provides an adequate basis for adopting interim relief.

IV. SPECIAL ACCESS PRICES SHOULD BE REINITIALIZED

A. Special Access Prices Should Be Reinitialized At Cost-Based, Forward-Looking Prices Using State-Approved UNEs Rates as Proxies

As discussed above, special access prices are far above forward-looking, cost-based levels; BOCs are earning unconscionable rates-of-return; pricing flexibility rules have backfired in that BOCs have used price cap relief to raise prices; and customers are being harmed by billions of dollars per year in overcharges under current rules. Accordingly, as part of permanent reform, the Commission should reinitialize special access prices that would then be subject to

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[57] *NPRM*, ¶ 114.

[58] Courts have held that "the Commission has the power to prescribe a change in contract rates when it finds them to be unlawful…and to modify other provisions of private contracts when necessary to serve the public interest." *Western Union Tel Co. v. FCC*, 815 F.2d 1495, 1501 (D.C. Cir. 1987). The FCC has exercised this authority and has granted "fresh look" relief in the past.

[59] Letter from Donna Epps, Verizon to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 (filed June 7, 2005).

modified price cap rules on a going forward basis. In choosing a market-based approach to access reform the Commission recognized that it may take several years for competition to reduce prices to competitive levels. It also emphasized that "[t]o the extent that competition did not fully achieve the goal of moving access rates toward costs, the Commission reserves the right to adjust rates in the future to bring them into line with forward-looking costs."[60] Thus, the Commission has already contemplated that reinitialization may be necessary in the circumstances presented here because the current regulatory framework has failed to produce reasonable prices.

More specifically, the Commission should reinitialize special access prices and set them at forward-looking economic cost based levels that are reflective of a competitive marketplace. The Commission has already concluded that "access charges should ultimately reflect rates that would exist in a competitive market" and that in a competitive market, rates should reflect forward-looking economic costs.[61] Rates should not be established based on historical accounting costs, *i.e.*, embedded costs.[62] As the Commission recognizes, "forward-looking costs are generally viewed as more relevant to setting prices in a competitive market" whereas embedded costs are not.[63]

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[60] *Access Charge Reform Order*, ¶ 48.

[61] *See Access Charge Reform Order*, ¶ 72.

[62] *Alenco Communications Co. v. FCC*, 201 F.3d 608, 615 (5th Cir. 2000) ("rates must be based not on *historical, booked costs*, but rather on *forward-looking, economic costs*. After all, market prices respond to current costs; historical investments, by contrast, are sunk and thus ignored").

[63] *NPRM*, ¶ 65 (explaining that "[e]mbedded costs are associated with past business decisions and generally are irrelevant to a rational profit-maximizing firm operating in a competitive market; only forward-looking costs matter to such a firm with regard to business decisions that it is required to make today.") (citing *See* Alfred E. Kahn, Timothy J. Tardiff, & Dennis L. Weisman, *The Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission*, 11 INFO. AND ECON. POLICY

Although it might be possible to debate the appropriate forward-looking methodology to apply to special access prices, the Commission should adopt a pragmatic and easily administrable approach at this point. Rather than setting new rates for BOCs' special access services based on comprehensive and detailed forward-looking cost studies, a pragmatic alternative is for the Commission to set special access prices at state-approved TELRIC prices for comparable UNEs.

This approach is by far a simpler and less burdensome method of setting initial rates because it does not require cost studies or an extensive rate investigation. In addition, although perhaps not the only acceptable forward-looking approach, TELRIC is a pricing approach already approved by the Commission (and the Supreme Court.) Although TSLRIC pricing methodology might also be acceptable, under both TSLRIC and TELRIC-based pricing methodologies,[64] prices reflect forward-looking economic costs, including a reasonable

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319, 324-25 (1999) ("Among economists, there is widespread agreement in principle that (1) the costs that would be the basis for efficient prices would be forward-looking, rather than historical and (2) the prices set on that basis should emulate the ones that would emerge from local exchange competition, if it were feasible."); Armen A. Alchian & William R. Allen, EXCHANGE AND PRODUCTION 222 (3d ed. 1983) ("Once [an item] is acquired, [its costs are] irrelevant to the setting of price in competitive markets."); N. Gregory Mankiw, PRINCIPLES OF ECONOMICS 291 (1997) ("The irrelevance of sunk costs explains how real businesses make decisions."); Paul A. Samuelson & William D. Nordhaus, ECONOMICS 167, (16th ed. 1998)).

[64] To elaborate, the Commission previously held that "Prescribing TSLRIC-based access rates would be the most direct, uniform way of moving those rates to [forward-looking economic] cost" indicative of a competitive marketplace. *Access Charge Reform Order*, ¶ 289. TSLRIC stands for "total service long run incremental cost" and "total service" refers to the entire quantity of the service (either single service or a class of similar services) that a firm produces, along with the costs of dedicated facilities and operations used in providing that service. *See Local Competition Order*, ¶ 677. "TELRIC rates" are rates for unbundled network elements and interconnection based on TELRIC cost assumptions. The FCC coined and adopted the term TELRIC in the *Local Competition Order* to describe a different version of that methodology, one based on the specific network element or elements to be priced. *Local Competition Order*, ¶ 678 (discussing both methodologies). Essentially, TELRIC is an unbundled version of TSLRIC methodology, pricing discrete network elements rather than entire

allocation of forward-looking joint and common costs, and allow incumbent LECs to earn a fair, risk-adjusted rate-of-return on their investments.[65] Moreover, as the Ad Hoc Report concludes, rates for special access services should be set at TELRIC ultimately.[66]

And, the Commission itself has already extensively reviewed and examined all of the BOCs' UNE rates when it was reviewing their 271 applications. During the § 271 proceedings and in approving all the § 271 applications, the Commission found, with minimal exceptions, that the state commissions followed basic TELRIC principles and established UNE rates that reflected the forward-looking economic cost of providing those elements.[67] Although the Commission never conducted a *de novo* review of a state's pricing determinations, it approved the applications so long as the rates were within a zone that a reasonable application of TELRIC would produce.[68] Accordingly, the Commission can be confident that state UNE prices closely approximate the forward-looking levels that would exist in a competitive market.

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services. The Commission has concluded that "in practice" TELRIC "prices are based on the TSLRIC of the network element."[64] *Local Competition Order*, ¶ 672.

[65] *1996 Special Access NPRM*, ¶ 222; *Local Competition Order*, ¶ 672.

[66] ETI White Paper at 3-4.

[67] *See Local Competition Order*, ¶¶ 672-78; 47 C.F.R. §§ 51.501 *et seq.* (1999).

[68] *See, e.g., Application by SBC Communications Inc., Pacific Bell Telephone Company, and Southwestern Bell Communications Services Inc., for Authorization To Provide In-Region, InterLATA Services in California*, WC Docket No. 02-306, Memorandum Opinion and Order, 17 FCC Rcd 25650, ¶ 71, Appendix C ¶ 45 (2002) ("*Pacific Bell California Order*"). To determine whether UNE rates are "outside the range that the reasonable application of TELRIC principles would produce," the Commission undertakes comparisons of rates in the applicant's state to rates it has previously found to be TELRIC-compliant in another state. *See Pacific Bell California Order*, ¶¶ 54 & 71; *see also Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, CC Docket No. 00-217, Memorandum Opinion and Order, 16 FCC Rcd 6237, ¶¶ 81-82 (2001) ("*SWBT Kansas/Oklahoma Order*"), *aff'd in part, remanded in part sub nom. Sprint Communications Co. v. FCC*, 274 F.3d 549 (D.C. Cir. 2001).

Further, UNE prices embody a degree of granularity in that UNE rates are state specific and reflect the forward-looking costs associated with providing facilities in each state. Alternatively, the Commission could establish a weighted average of UNE rates across a BOC region. Using an average, however, may be unnecessary because it appears that BOCs are already assessing state-specific special access rates as a result of pricing flexibility[69] and thus, using state specific UNE should not be at all burdensome for BOCs to implement.

Another excellent attribute associated with setting special access rates at UNE rate levels is that doing so will give BOCs an incentive to operate in a cost effective manner as a competitive market requires. Indeed, just as TELRIC provides BOCs with an incentive to operate in a forward-looking least-cost fashion, special access rates that reflect similar assumptions would provide the ILECs with the necessary incentive to operate in a similar manner because they would only be allowed to recover efficiently incurred costs.

Commenters emphasize that they are not wedded to TELRIC or state-approved UNE prices as the only acceptable forward-looking approach. However, given that the Commission has already determined that special access prices should be set a forward-looking pricing, state-approved UNE prices would appear to be the most readily available approach involving a minimum of burden on all parties concerned. State-approved UNE prices could also be used as an initial approach as a proxy for some other forward-looking approach that the Commission might choose as a permanent solution.

The Commission could consider ordering a phased-in reduction of forward-looking pricing. In the *Access Charge Reform Order*, the Commission explained that if the Commission

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[69] *See* Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), Attachment 1 & 2 (comparing, among other things, the different pricing flexibility rates for DS1 and DS3 services BOCs assess in each state).

"were to make such a rate prescription, we would consider phasing in the rate reductions of …over a period of years, in order to avoid the rate shock that would accompany such a great rate reduction at one time."[70] However, rate shock to ILECs should not weigh heavily in the balance given the unconscionable returns that BOCs have made on special access services over the past eight years along with the substantial and sustained price increases for such services with which they have gouged ratepayers. Thus, it is only fair that the rates be immediately adjusted to competitive levels rather than over a period of time.

B. The Commission Should At Least Re-Target Special Access At The 11.25% Authorized Rate-of-Return, Or Preferably An Updated Lower Return, Pending Forward-looking Pricing

To the extent the Commission decides (inappropriately) for whatever reason that special access prices should not be reinitialized now at forward-looking cost-based levels, the Commission should at least reinitialize special access rates based on embedded costs and the last-authorized 11.25% rate-of-return,[71] or preferably based on an updated rate-of-return as discussed below. This would reduce BOCs' excessive special access prices to a level that would hopefully eliminate the excessive special access earnings they presently enjoy while at the same time it would move rates towards forward-looking, cost-based levels. To implement this approach, the Commission would only need to (1) calculate, for the most recent calendar year, a price cap LEC's special access rate-of-return, based on ARMIS data; (2) calculate the percentage by which revenues would have had to have been lower to earn an acceptable rate-of-return; (3) reduce that price cap LEC's current special access rates across the board by that percentage; and (4) use these reduced rates as the initial rates under a new price cap plan.[72] To the extent the

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[70] *Access Charge Reform Order*, 12 FCC Rcd at 16107, ¶ 290.

[71] *See NPRM*, ¶ 60 (citing *LEC Price Cap Order*, ¶¶ 230, 247).

[72] *NPRM*, ¶ 64.

BOCs object to this approach and contend that the resulting rates do not allow them to recover their forward-looking costs fully, BOCs could be given the option of submitting cost studies to justify any rate increases they seek.

C. If the Commission Uses Cost Studies, It Should Employ an Updated Rate-of-Return – 11.25 Percent is Outdated and Unreasonably High

Of course, the Commission could also employ cost studies to set special access prices going forward, although this would be far more burdensome than using state approved UNE prices. In fact, the Commission had previously required price cap ILECs to submit forward-looking cost studies no later than February 8, 2001 for all services then remaining under price caps, although this never took place because the Commission permitted price cap ILECs to charge the higher prices contemplated under the CALLS Plan.[73]

In connection with any use of cost studies, the Commission should find that its prescribed 11.25 percent rate-of-return is no longer a valid benchmark for determining whether BOCs special access rates are just and reasonable. The 11.25 percent rate-of-return is approximately 15 years old. The costs of debt and equity financing along with capital structures employed that are reflected in the rate-of-return have dramatically changed since 1991. In particular, when the 11.25 percent rate-of-return was adopted in 1990, the prime rate was 10% and the 10-year US Treasury Bond was 8.89 percent (September 1990).[74] Today, those rates are 6.00 and 4.14 percent (June 2005) or 4 percentage points and 4.75 percentage points less, respectively.[75] If the Commission resets the authorized rate-of-return level, it should most likely be in the

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[73] *Access Charge Reform Order*, ¶¶ 48, 267; *see CALLS Order*, ¶ 20.

[74] ETI White Paper at 7.

[75] Federal Reserve Board, Statistic: Releases and Historical Data, *available at* http://www.federalreserve.gov/releases/h15/Current/ (accessed June 13, 2005).

8 percent to 9 percent range or lower, which is considerably less than the now-ancient 11.25%.[76] In establishing this rate-of-return, the Commission should: (1) establish a cost-of-capital that reflects the fact that competitors seek to access basic legacy loops and transport facilities that inherently have a lower risk; (2) require that the cost of capital be based on (a) a book value capital structure that recognizes short term debt financing, and (b) a cost-of-equity that is indicative of a comparable group of RBOCs; and (3) reject any risk premiums proposed.[77]

V. RECOMMENDED NEW PRICE CAP RULES

A. The Commission Should Re-Impose a Productivity-Based X-Factor

Once special access rates are reinitialized, the Commission should apply a modified price cap regime that ensures that special access rates remain at just and reasonable competitive levels going forward. In particular, the Commission should make a productivity-based X-Factor a key feature of new permanent price cap rules.

As the Commission has recognized, the telecommunications industry in general and LECs in particular, are characterized by productivity gains that are much greater than the economy as a whole. For that reason, in the 1990 in the *LEC Price Cap Order*, the Commission included an X-factor in the price cap regime that required prices cap ILECs to reduce prices annually based on productivity gains.[78] Absent an X-Factor, the price cap plan did not adequately account for the higher than average growth in LEC productivity that has resulted in lower than average telephone prices, relative to inflation.[79] The X-Factor assured that customers would obtain some of the benefits of improvements in efficiency in the form of lower prices.

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[76] *See* ETI White Paper at 7.

[77] For further discussion of these recommendations, *see* Reply Comments of Allegiance, et al, WC Docket no. 03-173, at 26-36 (dated January 30, 2004).

[78] *LEC Price Cap Order*, ¶¶ 74-119.

[79] *LEC Price Cap Order*, ¶ 75.

The current price cap regime, however, does not, in effect, have an X-Factor because under the *CALLS Order* the Commission unlawfully morphed the X-Factor into a negotiated non-productivity-based transitional mechanism that reduced switched access rates to a specific target and lowered special access rates for a specified period of time.[80] The special access X-factor was set at 3.0 percent in 2000, 6.5 percent for the next three years, and equal to the GDP-PI thereafter, essentially freezing the special access PCI (after accounting for exogenous cost adjustments).[81] Therefore, at the present time, the X-Factor is equal to zero and all the alleged efficiency gains that BOCs have touted to the Commission as benefits of their various anticompetitive proposed mergers produce no benefit at all for special access customers. Thus, the CALLS Plan fails to recognize that the "telecommunications industry has historically been more productive than the American economy as a whole"[82] and does not adequately account for the higher than average growth in LEC productivity that has resulted in lower than average telephone prices, relative to inflation.[83] Thus, under the current price cap plan, BOCs are the only beneficiaries of productivity gains.

To address this shortcomings and consistent with its justification in the *LEC Price Cap Order*, the Commission should re-impose a productivity-based X-factor in the price cap formula to ensure that rates continue to decline relative to the measure of inflation, GNP-PI.[84] Although the Commission should, at a minimum, apply the X-factor prospectively, it should also apply it

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[80] *CALLS Order*, ¶ 140.

[81] *CALLS Order*, ¶ 149.

[82] *LEC Price Cap Order*, ¶ 75.

[83] If it did, an X-factor productivity offset would need to be included in the price cap formula, to ensure that rates continue to decline relative to the measure of inflation, GNP-PI. *See LEC Price Cap Order*, ¶ 75.

[84] *See LEC Price Cap Order*, ¶ 75.

retroactively back to 2004, when the Commission, under the CALLS Plan, effectively eliminated the X-factor and froze the PCI.

B. The Commission Should Re-impose an Earning Sharing Requirement

In the *1997 Price Cap Review Order*, the Commission eliminated the sharing requirements, finding that sharing severely blunts the incentives of price cap regulation by reducing the rewards for ILEC efficiency gains.[85] It further found that eliminating sharing requirements abolished "a major vestige of rate-of-return regulation that had created incentives to shift costs between services to evade sharing in the interstate jurisdiction."[86] Contrary to the tentative conclusion in the *NPRM*,[87] the Commission should require ILECs to share earnings up to a certain level and return 100 percent of any earnings that exceed that level, similar to its previous requirements.[88]

As the Commission previously acknowledged, sharing serves a number of useful purposes. First, it serves a "backstop" function - it helps ensure that any errors in the X-factor (or in reinitialization of prices in this proceeding) do not lead to unreasonably high rates.[89] Second, it serves a "flow-through" function – it helps ensure that LEC reductions in unit costs are passed through to their customers.[90] Third, it serves a "useful matching" function in a price cap plan – it encourages LECs to adopt an X-factor that most closely match[es] their internal

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[85] *1997 Price Cap Review Order*, ¶ 148.

[86] *1997 Price Cap Review Order*, ¶ 148.

[87] *NPRM*, ¶ 44.

[88] *See NPRM*, ¶ 41-42 (citing *LEC Price Cap Order*, ¶ ¶ 122-26; *1995 Price Cap Review Order*, 10 FCC Rcd at 8970-71, ¶¶ 19-20).

[89] *See 1997 Price Cap Review Order*, ¶ 147 (citations omitted).

[90] *See 1997 Price Cap Review Order*, ¶ 147 (citations omitted).

expected rate of productivity growth.[91] Fourth, it serves an "accuracy" function – it reduces the incentive for BOCs to pad their costs as a safeguard against future investigation of rates.

The Commission's concern that sharing would increase a BOC's incentive to shift costs to the intrastate jurisdiction is misguided.[92] The overwhelming majority of special access facilities are interstate, *i.e.*, there is more than 10 percent interstate usage over these facilities making them subject to federal jurisdiction under the Commission's "ten percent rule."[93]

Moreover, requiring sharing is equitable in that BOCs are not entitled to excessive earnings. Accordingly, the Commission should reestablish a sharing mechanism as part of new price cap rules.

C. Low End Adjustments Should Be Reset Substantially Lower

In the *LEC Price Cap Order*, the Commission adopted a low-end adjustment mechanism applicable to LECs earning below 10.25 percent that protected price cap LECs from such low earnings over a prolonged period of time so as to grossly impair the LEC's ability to attract capital and to provide services.[94] In the *Pricing Flexibility Order*, the low end-adjustment was altogether eliminated for price cap LECs that qualify for and elect to exercise either Phase I or Phase II pricing flexibility.[95] The Commission retained the low-end adjustment for carriers that

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[91] *See 1997 Price Cap Review Order*, ¶ 147 (citations omitted).

[92] *NPRM*, ¶¶ 43-44.

[93] *MTS and WATS Market Structure, Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, Decision and Order, 4 FCC Rcd 5660, ¶¶ 2, 6-7 (1989) (under the ten percent rule, the cost of a mixed use line is directly assigned to the interstate jurisdiction only if the line carries interstate traffic in a proportion greater than ten percent).

[94] *LEC Price Cap Order*, ¶ 147. The low-end adjustment to the PCI formula permits price cap LECs that earn a rate-of-return less than 10.25 percent in a given year temporarily to increase their PCIs in the next year to a level that would allow them to earn 10.25 percent. *NPRM*, ¶ 45 (citations omitted).

[95] *Pricing Flexibility Order*, ¶ 162.

have not qualified for and elected to exercise either Phase I or Phase II pricing flexibility to protect these LECs from events beyond their control that would affect earnings to an extraordinary degree.[96] In the *NPRM*, the Commission tentatively concludes that if it adopts a price cap plan for special access services, it should retain a low-end adjustment mechanism for ILECs that have not implemented pricing flexibility.[97]

Commenters have no objection to a low end adjustment for those price cap LECs that have not elected pricing flexibility, provided that a LEC continues to lose the ability to obtain a low end adjustment on a company wide basis, *i.e.* if the LEC obtains pricing flexibility anywhere then it may not obtain a low end adjustment for any of its operations. Further, if the low end adjustment is retained, it should be reset lower than 10.25%.

D. Separate Baskets Should Be Established for DS1, DS3, Mass Market Broadband and DSL, and Retail Special Access Services

At the present time, high capacity services comprise a category within the special access basket.[98] DS1 and DS3 services are subcategories within the high capacity category.[99] As

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[96] *CALLS Order*, ¶¶ 181-82.

[97] *NPRM*, ¶ 47.

[98] A price cap basket is a broad grouping of services. *NPRM*, ¶ 48. Currently, all special access services fall within the same basket. *LEC Price Cap Order*, ¶ 203.

[99] The special access basket currently contains the following categories and subcategories:

(i) Voice grade special access, WATS special access, metallic special access, and telegraph special access services;

(ii) Audio and video services;

(iii) High capacity special access, and DDS services, including the following subcategories:

(A) DS1 special access services; and

(B) DS3 special access services;

(iv) Wideband data and wideband analog services.

47 C.F.R. §61.42(e)(3).

noted elsewhere in these comments, BOCs continue to possess market power in provision of special access service. Although there is now limited competition, there was even less competition in 1990 at the time the Commission created the special access basket comprised of high capacity and other services. Assuming a single basket for all special access services may have made sense in 1990, at the present time it affords BOCs too much discretion to balance reductions for a service that may be experiencing some competition with increases for less competitive services. In fact, substantial evidence currently demonstrates that BOCs are doing just that.[100] One recent example are the special access rate changes SBC-California proposed on April 29, 2005 where it increased the rates for less competitive DS1 and DS3 facilities and concurrently decreased dramatically the rates for more competitive OCn facilities.[101] BOCs should not be permitted to offset rate decreases for services for which there are some competitive alternatives with rate increases for services for which there are no competitive alternatives.[102]

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[100] *See NPRM*, n.153 (citing AT&T Reply at 23-24 ("[Verizon's] channel termination portion of the total price for a single 10-mile two-ended DS-3 access circuit increased by 36%, while the transport component remained unchanged. For DS-1 circuits, Verizon increased channel terminations in some Phase II areas by as much as 24%, while increasing transport by only 4%. . . . For example, while Verizon South's DS3 entrance facility rates in Phase II areas are 13% higher than those in price capped areas, Verizon South's DS3 channel termination rates in Phase II areas are *71%*; higher than in priced cap areas." (emphasis in original)), Reply Declaration of Lee L. Selwyn at 8-10).

[101] *See* SBC Communications Inc. (Pacific Bell Telephone Company, Tariff F.C.C. No. 1), Transmittal No. 223 (filed Apr. 29, 2005) (increasing the DS1 and DS3 rates (proposed revised pages 7-172, 7-179, 7-183, 7-191, 7-192) and decreasing OCn rates (proposed revised pages 20-34, 20-35, 20-40, 20-41, 20-42).

[102] *See NPRM*, ¶ 51. For instance, a DS1 and DS3 channel termination services extending between the LEC end office and the customer premises often are subject to little or no competition. *See NPRM*, ¶ 51. However, competition may not be quite so limited for DS1 and DS3 channel terminations extending between the IXC POP and the LEC serving wire center, and for DS1 and DS3 channel mileage facilities extending between the LEC end office and the LEC serving wiring center. *See id*.

Accordingly, the Commission should tighten up the current price cap structure to limit the ability of BOCs to, in effect, cross-subsidize competitive price reductions with increases elsewhere.

To prevent BOCs from cross-subsidizing in the competitively sensitive provision of high capacity services, the Commission should establish separate baskets for DS1 and DS 3 special access services and create categories under these baskets that recognize the relevant product markets associated with these services. The four categories should include: (1) special access channel terminations between the LEC end office and the customer premises (*i.e.*, loops); (2) channel mileage between LEC central offices (*i.e.*, transport); (3) special access channel terminations between the IXC POP and the LEC serving wire center (entrance facilities) and (4) any other special access product related to the basket.[103] High capacity services above the DS-3 level (*e.g.*, OCn) should be placed in a separate basket that does not include categories insofar as the Commission's determination is correct that the market for these services is competitive.[104]

The Commission should also establish a separate basket for mass market broadband and DSL services. In the *NPRM*, the Commission noted that these services compete directly with mass market cable and wireless broadband offerings.[105] If BOCs want to compete for these mass

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[103] The 5 percent upper pricing band that currently applies to special access services and categories should also apply to the baskets and categories being proposed herein "to protect ratepayers from substantial changes in services rates." *See LEC Price Cap Order*, ¶¶ 223-24; 47 C.F.R. § 61.47(e).

[104] *See, e.g., TRO*, ¶¶ 315 & 389.

[105] *NPRM*, ¶ 52 (citing *See generally Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, GN Docket No. 04-54, Fourth Report to Congress, FCC 04-208 (rel. Sept. 9, 2004) (concluding that "advanced telecommunications capability is

market customers, they should not be permitted to offset a competitive rate for mass market broadband or DSL service with increased rate for special access DS1 enterprise loop in an area where there is little or no competition. Nor should enterprise high capacity services in any way be responsible for subsidizing the costs associated with BOC's deployment of mass market broadband services. Significantly, the Commission declined to impose unbundling obligations on mass market broadband transmission capabilities in order to promote the investment in, and deployment of next generation networks to the mass market.[106] BOCs should not be permitted to offset their costs of deploying such mass market broadband services with the revenues received from providing high capacity enterprise services. To prevent such anticompetitive conduct and cross subsidization, the costs and revenues associated with mass market broadband and DSL services should be assigned to a separate basket.[107]

In addition, the Commission should establish a separate basket for other retail services. This will limit a BOC's ability to offset rate decreases that apply to services purchased by a end-user customer with rate increases that apply to services purchased by a wholesale customer (*e.g.*, a rate increase for wholesale DS3 or for DS1 and DS3 channel termination services purchased by IXCs).

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being deployed on a reasonable and timely basis to all Americans," and discussing different types of advanced telecommunications facilities).

[106] *See TRO*, ¶ 272.

[107] BOCs have averred that ARMIS special access revenues includes DSL revenues but not DSL lines so that the average revenue per special access line is overstated. Although these arguments have been refuted, *see* Declaration of Lee Selwyn (Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 14-16; Reply Declaration of Lee Selwyn (Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004) at 73, putting mass market broadband and DSL revenues in a basket that is not intermixed with other special access revenues should put to rest any remaining concerns.

The Table below illustrates Commenters' proposal for baskets and categories.

DS1 Basket	**DS3 Basket**	**OCn Basket**	**Mass Market Broadband and DSL Services Basket**	**Other Retail Services Basket**
Categories	**Categories**			
(i) DS1 Channel Terminations	**(i) DS3 Channel Terminations**			
(ii) DS1 Channel Mileage	**(ii) DS3 Channel Mileage**			
(iii) DS1 Channel Terminations to IXC POP	**(iii) DS3 Channel Terminations to IXC POP**			
(iv) DS1 Other	**(iv) DS3 Other**			

Finally, as it tentatively concluded,[108] the Commission should not re-impose lower pricing bands for the baskets, service categories or subcategories. In order to foster lower prices and encourage LECs to charge rates that reflect the underlying costs of providing exchange access services, the Commission previously found that there is no need for lower service band indices.[109] It further held that the PCI and upper pricing bands adequately control predatory pricing and that greater downward pricing flexibility would benefit consumers both directly through lower prices and indirectly by encouraging only efficient entry.[110] The same rationale justifies not re-imposing the lower pricing bands.

VI. PHASE II PRICING FLEXIBILITY SHOULD BE ABOLISHED, OR REVISED ONLY TO PERMIT PRICE REDUCTIONS

In its 1998 *Pricing Flexibility Order*, the Commission recognized that its new Phase II pricing flexibility rules relieving special access service from price cap regulation in qualifying MSAs could "lead to higher rates for access to some parts of an MSA that lack a competitive alternative.…"[111] It also recognized that "the regulatory relief we grant upon a Phase II showing

[108] *NPRM*, ¶ 56.

[109] *Access Charge NPRM, Order, and NOI*, 11 FCC Rcd at 21487-88, ¶ 305.

[110] *Id*.

[111] *Pricing Flexibility Order*, ¶ 142.

may enable incumbent LECs to increase access rates for some customers."[112] The Commission chose to grant Phase II relief despite the possibility of rate increases because it believed that its price cap rules may have required incumbent LECs to price access services below cost in certain areas, and because Phase II triggers indicated the presence of significant competition and "the public interest is better served by permitting market forces to govern the rates for access services at this point."[113] The Commission also noted that access services are generally purchased by IXCs, who are sophisticated purchasers fully capable of finding competitive alternatives where they exist. [114] More broadly, the Commission recognized that its pricing flexibility thresholds were "policy determinations" and were not an "exact science."[115]

Whatever little merit the Commission's 1999 "policy determination" may have had at that time, there is now no justification to permit price increases as part of Phase II relief. First, as already shown in the record of this proceeding, BOCs have raised prices where they have been granted Phase II pricing flexibility. These are large metropolitan areas, not areas where BOCs even theoretically could have been required to offer service below cost. In any event, the Commission's unsupported 1999 speculation about below cost pricing is now invalidated by the astronomical rates-of-return that BOCs are earning on special access service as shown by their own reporting to the Commission. Simply stated, there is no realistic possibility that BOCs are providing special access service below cost anywhere, or even if they are, it is so limited as to not be entitled to any weight in the Commission's public interest balancing. Thus, the

[112] *Pricing Flexibility Order*, ¶ 155.

[113] *Id.*

[114] *Id*.

[115] *Pricing Flexibility Order*, ¶ 96.

Commission's concern about the theoretical possibility of below cost pricing does not now, if it ever did, justify a regulatory scheme that permits widespread or any price increases.

Further, price increases due to lack of competitive alternatives has not been confined to "some parts of an MSA" as the Commission contemplated. Rather, they have occurred throughout the MSA qualifying for Phase II pricing flexibility. Thus, far greater price increases have occurred than what the Commission contemplated in light of the fact that it chose to grant Phase II pricing flexibility before competitive alternatives were available to reach every end user in an MSA. In addition, the Commission envisioned that price increases would overall be offset by price reductions that would be occasioned by competition. In fact, special access prices have not been reduced where Phase II pricing flexibility has been granted. Therefore, Phase II pricing flexibility has harmed customers without providing any substantial benefits.

Also, there is no basis for permitting BOCs to increase prices based on a showing of competition. Competition should put downward pressure on prices and, therefore, there is no theoretical basis for permitting any price increase based on a showing of competition. Moreover, as discussed, experience has shown that BOCs have not decreased prices under Phase II pricing flexibility. Therefore, competition is not sufficient to constrain prices. Customers have received no benefits from Phase II pricing flexibility, and, in fact, have been harmed because service in those areas has not been subject to any X Factor reductions that would otherwise have applied under the CALLS plan. In fact, prices are higher in Phase II pricing flexibility areas than in areas that remain subject to prices caps. Phase II pricing flexibility has been no more than a huge windfall for price cap ILECs. Accordingly, the Commission should simply abolish Phase II pricing flexibility.

To the extent Phase II relief is retained (which the Commission should not do) including any relief from any aspects of price cap regulation such as application of the X-Factor, Phase II relief should permit only price reductions. Given that the theoretical basis for price cap relief is that competition will be sufficient to drive prices to forward-looking costs, downward pricing flexibility is all this is necessary to permit BOCs to respond to competitive pressure. Limiting relief to downward pricing will also provide a safeguard to the extent that any test for Phase II pricing flexibility errs in identifying the existence of competition sufficient to constrain prices.

VII. BOC TERMS AND CONDITIONS OF SPECIAL ACCESS ARE UNLAWFUL

A. Region Wide Commitments and Restrictions on Use of UNEs Are Unreasonable and Anticompetitive

In the *NPRM*, the Commission notes that market power can be expressed through unreasonable terms and conditions of service in addition to price and asks for comment regarding any such unreasonable terms and conditions. [116] In this connection, it should come as no surprise that the BOCs employ blatantly anticompetitive terms and conditions in their special access service offerings. The FCC has found within the past six months at least one special access offer that was anticompetitive and designed to benefit ILEC affiliates to the detriment of competitors. The Commission found that BellSouth's "Transport Savings Plan" and its "Premium Service Incentive Plan unlawfully discriminated against interexchange carriers by offering a term and volume discount plan that was especially favorable to its own long distance affiliate.[117]

Other terms and conditions that BOCs currently employ are also anticompetitive. In particular, requirements for region-wide purchases and restrictions on the use of UNEs as

[116] *NPRM*, ¶¶ 114-125.

[117] *AT&T Corp. v. BellSouth Telecommunications, Inc.*, File No. EB-04-MD-010, Memorandum Opinion and Order, FCC 04-278 (rel. Dec. 9, 2004).

preconditions of discounts severely constrain competitive choices for CLECs. SBC's recent Special Access Service Offer, Contract Offer No. 34 in the Pacific Bell interstate tariff, provides some fairly egregious examples.[118] The Offer is also made in the other SBC affiliate tariffs: SWBT Tariff F.C.C. No. 73, Section 41, Contract Offer No. 31; Ameritech Tariff FCC No. 2, Section 22, Contract Offer No. 43; Nevada Tariff F.C.C. No. 1, Section 23, Contract Offer No. 2; and The Southern New England Telephone Company Tariff F.C.C. No. 39, Section 25, Contract Offer No. 6)

First, SBC places restrictions on the use of UNEs in order to obtain discounts by requiring the Customer to maintain an "Access Service Ratio equal to or greater than 98%." The Access Service Ratio compares a Customer's total purchases of Special Access services to the combination of purchases of Special Access services and Wholesale unbundled network element services. (In other words, Access Revenue divided by Access Revenue plus Wholesale Revenue). A Customer that obtains any significant amount of UNEs from SBC can never satisfy this condition because as the volume of UNE purchases increases (thereby increasing the denominator in the calculation), the ratio of special access services to UNEs plus special access services decreases. This restriction creates a significant disincentive to exercise rights provided under the Telecom Act to purchase UNEs from SBC, even if they may be priced substantially below special access rates.

Second, and more importantly, in order to qualify for the discounts in Pacific Bell Contract Offer No. 34, the Customer "must concurrently subscribe to the parallel Contract

[118] *See* Pacific Bell Telephone Company, Tariff F.C.C. No. 1, Section 33.34, Contract Offer No. 34. By its terms, Contract Offer No. 34 was available only until January 17, 2005, but nothing currently prevents SBC from offering similar terms and conditions in the future.

Offers" offered by all of the SBC affiliates throughout the SBC service territory.[119] Each of those Contract Offers has similar eligibility requirements, thereby compelling the Customer to maintain eligibility everywhere in the SBC territory, or lose it everywhere in the SBC territory. In other words, the Customer must not only satisfy all of the conditions under the Pacific Bell service offering, but also satisfy on a continuing basis, all of the conditions under the SWBT, Ameritech, Nevada Bell, and SNET special access tariffs as well. Failure to satisfy any single condition in the corresponding contract offers potentially could negate the discount offer throughout all of the service territories, which, if correct, would be unlawful and unreasonable in any event. For example, if a Customer buys one too many DS3 UNE Loops in Reno, Nevada, and falls below the 98% "Access Service Ratio" under the SBC Nevada special access tariff, the Customer will lose its discounts not only in Reno, Nevada, but also in San Francisco, Dallas, Chicago, San Diego, or any other city in which the SBC contract offering is applicable, even if all of the conditions in those cities were satisfied for those cities.

These Contract Offer conditions are in addition to minimum annual revenue commitments and term commitments. Failure to maintain the minimum annual revenue commitments in a single state would also result in losing the term and volume discounts based on those commitments throughout the SBC region.

Even though the Customer is given a substantial discount from the full price for the particular special access service if it satisfies each and every condition of service, these special contract offers illustrate the utter lack of competitive choices available to subscribers of BOC special access services. There is simply no valid cost justification for losing a substantial volume discount throughout the SBC service territory if a Customer makes the mistake of purchasing one

[119] *See* Pacific Bell Telephone Company, Tariff F.C.C. No. 1, Section 33.34.3(A), Contract Offer No. 34.

too many DS3 UNE loops. Given the consequences of losing all discounts obtained by agreeing to the Contact Offer, the safe choice for the Customer is to avoid purchasing any UNEs in the SBC service territory in order to satisfy the Access Service Ratio and not lose the volume discounts.

Further, SBC is able to leverage its enormous geographic service territory to squeeze out competitors anywhere in its territory. Contact Offer No. 34 is an example of its ability to demand non-competitive terms in cities where it faces no competition to apply to cities in which it does face competition. By requiring a Customer to maintain service level commitments in states in which SBC faces competition in order to obtain substantial discounts in states where SBC faces little or no competition, SBC can effectively eliminate whatever competition it may face by making the choice of competitive service highly unattractive.

As a result of anticompetitive terms and conditions like the eligibility requirements in Pacific Bell Contract Offer No. 34, purchasers of special access services from SBC are harmed in the long term by the absence of competitive transport providers. If SBC faced sufficient competition in all of its states, it would be unable to demand region-wide restrictions. Rather than be required to purchase from the *prix fixe* region-wide menu offered by SBC, a Customer could buy competitive transport services *a la carte* from each carrier that makes the best offer in each city served by an SBC affiliate. If SBC ever faced such competition, it would be compelled to improve service, lower prices, or offer new products to expand its business. Instead, SBC exploits its market power to impair competitive entry and maintain its monopoly status.

The Commission should rule in this proceeding that restrictions and conditions for term and volume discounts that require a Customer to obtain similar services from a BOC on a region-

wide basis, or that place restrictions on the use of UNEs in order to obtain discounts, are discriminatory, anticompetitive, and unlawful.

B. "Fresh Look" Relief is Warranted

The Commission should also establish a "fresh look" opportunity for customers of special access. In light of BOCs excessive earnings and imposition of unreasonable terms and conditions, customers should be given the option of obtaining service from other providers regardless of term commitments and without penalty.

VIII. CONCLUSION

For the foregoing reasons, the Commission should adopt the recommendations made herein.

Respectfully submitted,

/s/ Patrick J. Donovan

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Dated: June 13, 2005